Economic Viewpoint
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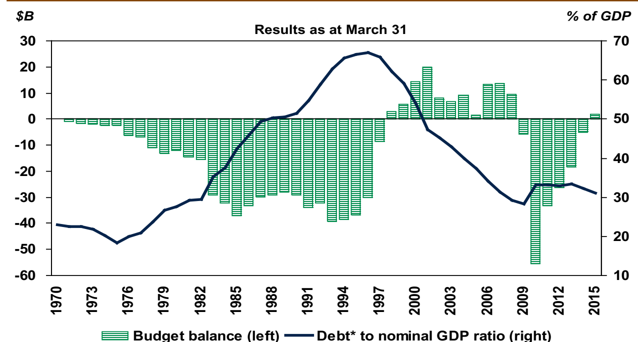
The federal government has some leeway in terms of budget deficits

According to the results for the public accounts, the Canadian government posted a $1.9B budget surplus in 2014-2015, ending a six-year run of deficits. However, deficits are expected to be back in upcoming years due to worsening economic conditions and the initiatives being planned by the new federal government. This *Economic Viewpoint* sets out some benchmarks for how big upcoming budget deficits can get without compromising the federal government's financial health. There seems to be considerable financial leeway, as deficits could be between $10B and $20B a year, based on relatively prudent assumptions. Deficits could even be a little larger in the event that a slightly higher indebtedness ratio is tolerated.

The federal government's financial position worsened substantially during the 1980s and early 1990s, when sizable budget deficits made the debt skyrocket. At the time, the high debt load attracted numerous criticisms, both in Canada and internationally, prompting the Canadian government to undertake work to clean up the public finances. A first budget surplus was achieved in fiscal 1997-1998; it was followed by 10 more consecutive budget surpluses. This substantially helped to reduce the size of the federal government's debt load, taking the debt to GDP ratio from a peak of 67.1% on March 31, 1996, to just 28.2% on March 31, 2009 (graph 1). The Great Recession of 2008-2009, however, eroded Canada's public finances and the federal government's budget balance went back into the red as of fiscal 2008-2009. Nonetheless, a balanced budget remained a government priority, gradually whittling away the deficits to achieve a slight surplus in fiscal 2014-2015. The debt to GDP ratio stabilized at 31.0% on March 31, 2015.

According to the update released this fall by the new federal government, the budget could edge back into negative territory in 2015-2016, primarily as a result of the adverse impacts of the drop in commodity prices and erosion of Canada's economic conditions. The projected $3.0B deficit[1], combined with much slower nominal GDP growth, will favour an uptick in the debt to GDP ratio, which could go to 31.1% as at March 31, 2016.

Graph 1 The federal government s financial position has improved substantially since the end of the 1990s



* Debt representing accrued deficits
Sources: Department of Finance Canada and Desjardins, Economic Studies

It is in this context that Canada's new government will table its first budget for fiscal 2016-2017 this winter. Tax cuts have already been ordered for the middle class and other measures are expected, including a major increase to the federal government's infrastructure investment program. These measures will obviously impact the federal government's expenditures and revenues; it is clear that fiscal 2016-2017 will end with a much bigger deficit than the $3.9B estimated last fall. This observation raises two primary questions. Firstly, can the federal government actually allow itself to go back to budget deficits? Secondly,

1. Note that these projections do not factor in the new measures introduced by the federal government.

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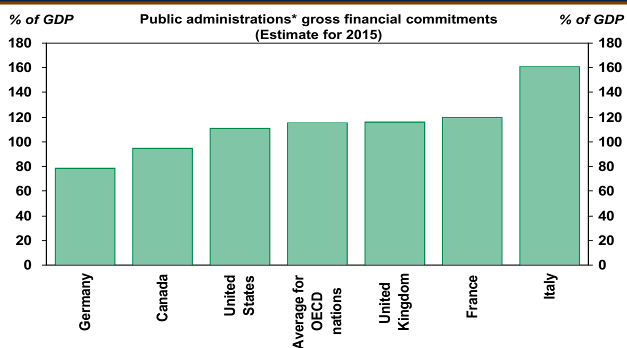
how big can the deficits get without compromising the federal government's financial health?

CANADA IS IN A FAIRLY GOOD FINANCIAL POSITION

At the outset, note that achieving a balanced budget is no longer a key condition in managing Canada's public finances. The clean-up of the public finances generated a net reduction in the federal debt to nominal GDP ratio; the result is that Canada's debt load is now lower than that of most other industrialized nations. International comparisons by the Organisation for Economic Co-operation and Development (OECD) on the size of the aggregate debt of all tiers of government show that Canada's gross financial commitments are below the average for industrialized nations (graph 2). Among the G7 nations alone, only Germany has a lower public indebtedness ratio than Canada. The United States, United Kingdom, France, Italy and Japan all have higher debt rates. This shows that Canada now has some leeway in terms of the debt. As the federal government only accounts for about 40% of the aggregate liability of all of the country's public administrations, it can, to a point, permit itself to incur budget deficits in coming fiscal years without throwing too much of a monkey wrench into Canada's financial position. That being said, caution is in order given the excesses of the past and the state of the provinces' public finances, with several provinces still grappling with budget deficits.

Graph 2 The relative weight of Canada's public debt is below the average for industrialized nations



* Aggregation of central, state and local governments, and the social security administrations affiliated with these entities.
Sources: Organisation for Economic Co-operation and Development (OECD) and Desjardins, Economic Studies

Planned budget deficits may therefore be justified in a context in which many players think that accelerating public spending or lowering the burden on taxpayers could stimulate Canada's economic growth and thus take up the slack from a monetary policy that is nearing the threshold of its traditional realm of intervention, with interest rates at almost zero. Moreover, an increase in public investment could facilitate the Canadian economy's current transition, as resources in the commodity sector are redirected to other sectors of the economy, such as services and manufacturing. All in all, this could help improve the Canadian economy's growth potential, which has been affected by the recent difficulties.

The door therefore seems to be open to Canadian budget deficits. That being said, how big could the deficits get in the coming years? In theory, the ceiling is fairly high. In practice, however, the federal government's budget planning should respect two criteria. For one thing, a substantial erosion of the federal government's financial position has to be avoided, as this would sacrifice the hard-won ground gained during the fight to clean up the public finances in previous decades. This means that the debt to GDP ratio must be kept close to its current level. For another, we must not relapse into a spiral of major structural deficits as happened in the 1970s and 1980s. To do this, the federal government will have to maintain a budget deficit control plan and, ideally, set benchmarks for eventually balancing the budget again.

FAIRLY EXTENSIVE FINANCIAL LEEWAY

Even in meeting these two criteria, the federal government will still have a lot of financial leeway in the years to come. To begin with, however, we need to set out some assumptions for movements by nominal GDP growth in the next few years. According to our latest scenario, growth of just 0.7% is expected for 2015 due to the negative impacts of the drop in commodity prices and the technical recession. A gradual rise by energy prices, combined with improved economic conditions, should however allow for some acceleration in the next few years. Nominal GDP growth of 2.2% and 4.2% is forecast for 2016 and 2017, respectively. More modest growth is anticipated after that as a result of the Canadian economy's lower growth potential.

According to this scenario, the federal government could plan for a nearly $15B deficit for fiscal 2016–2017, while still keeping the debt to GDP ratio at 31.1%. The leeway remains for subsequent fiscal years: deficits could be around $25B while maintaining a steady indebtedness ratio (table 1 on page 3).

However, many uncertainties surround these projections. Among other things, the economy could grow less than projected. However, still using more conservative assumptions about nominal GDP growth, the federal government could continue to plan for fairly large deficits in the coming years, between $10B and $20B (table 2 on page 3). In fact, it would take zero or negative nominal GDP growth for the federal government not to be able to run a budget deficit without increasing its indebtedness ratio. However, nominal GDP nearly always goes up, if only as a result of price increases.

Table 1 – Budgetary and economic projections (base version)

Fiscal years	Nominal GDP* ($M)	Annual nominal GDP growth* (%)	Budget balance ($M)	Budget balance (% of GDP)	Debt representing accrued deficits ($M)	Debt ratio for accrued deficits in relation to nominal GDP** (%)
2005-2006	1,417,028	6.4	13,218	0.93	481,499	34.1
2006-2007	1,492,207	5.3	13,752	0.92	467,268	31.4
2007-2008	1,573,532	5.4	9,597	0.61	457,637	29.2
2008-2009	1,652,923	5.0	-5,755	-0.35	463,710	28.2
2009-2010	1,567,365	-5.2	-55,598	-3.55	519,097	33.1
2010-2011	1,662,130	6.0	-33,372	-2.01	550,327	33.1
2011-2012	1,769,921	6.5	-26,279	-1.48	583,576	33.0
2012-2013	1,822,808	3.0	-18,415	-1.01	609,391	33.3
2013-2014	1,892,193	3.8	-5,150	-0.27	611,881	32.3
2014-2015	1,973,043	4.3	1,911	0.10	612,330	31.0
2015-2016 e	**1,986,877**	**0.7**	**-3,000**	**-0.15**	**616,500**	**31.1**
2016-2017 p	**2,030,589**	**2.2**	**-15,013**	**-0.74**	**631,513**	**31.1**
2017-2018 p	**2,115,873**	**4.2**	**-26,524**	**-1.25**	**658,037**	**31.1**
2018-2019 p	**2,196,277**	**3.8**	**-25,005**	**-1.14**	**683,042**	**31.1**
2019-2020 p	**2,277,539**	**3.7**	**-25,273**	**-1.11**	**708,315**	**31.1**
2020-2021 p	**2,361,808**	**3.7**	**-26,208**	**-1.11**	**734,522**	**31.1**

**: Data on nominal GDP come from a regular calendar that starts in January of the previous fiscal year.*

***: Due to rounding, among other factors, the results may not match the department's calculations exactly.*

e: Department estimates established for the November 20, 2015 budget update.

p: Projections

Table 2 – Budgetary and economic projections (prudent version)

Fiscal years	Nominal GDP* ($M)	Annual nominal GDP growth* (%)	Budget balance ($M)	Budget balance (% of GDP)	Debt representing accrued deficits ($M)	Debt ratio for accrued deficits in relation to nominal GDP** (%)
2005-2006	1,417,028	6.4	13,218	0.93	481,499	34.1
2006-2007	1,492,207	5.3	13,752	0.92	467,268	31.4
2007-2008	1,573,532	5.4	9,597	0.61	457,637	29.2
2008-2009	1,652,923	5.0	-5,755	-0.35	463,710	28.2
2009-2010	1,567,365	-5.2	-55,598	-3.55	519,097	33.1
2010-2011	1,662,130	6.0	-33,372	-2.01	550,327	33.1
2011-2012	1,769,921	6.5	-26,279	-1.48	583,576	33.0
2012-2013	1,822,808	3.0	-18,415	-1.01	609,391	33.3
2013-2014	1,892,193	3.8	-5,150	-0.27	611,881	32.3
2014-2015	1,973,043	4.3	1,911	0.10	612,330	31.0
2015-2016 e	**1,986,877**	**0.7**	**-3,000**	**-0.15**	**616,500**	**31.1**
2016-2017 p	**2,016,681**	**1.5**	**-10,688**	**-0.53**	**627,188**	**31.1**
2017-2018 p	**2,077,181**	**3.0**	**-18,816**	**-0.91**	**646,003**	**31.1**
2018-2019 p	**2,139,496**	**3.0**	**-19,380**	**-0.91**	**665,383**	**31.1**
2019-2020 p	**2,203,681**	**3.0**	**-19,962**	**-0.91**	**685,345**	**31.1**
2020-2021 p	**2,269,792**	**3.0**	**-20,560**	**-0.91**	**705,905**	**31.1**

**: Data on nominal GDP come from a regular calendar that starts in January of the previous fiscal year.*

***: Due to rounding, among other factors, the results may not match the department's calculations exactly.*

e: Department estimates established for the November 20, 2015 budget update.

p: Projections

The federal government could also opt to tolerate an uptick in its debt ratio in the event that economic conditions erode more than anticipated, among other situations. For example, the Department of Finance could set a medium-range debt to GDP ratio target of around 35%, slightly higher than the target in the years that followed the Great Recession. Therefore, even if we use even lower assumptions for economic growth than used in the prudent version, the possibility of slightly increasing the indebtedness ratio would allow the federal government to incur fairly large budget deficits in the coming years, between $22B and $41B (table 3).

For another, the federal government cannot overlook the provinces' financial positions. Several provinces are still grappling with budget deficits, helping to increase the country's aggregate debt load. This reduces the federal government's leeway in terms of budget deficits; otherwise, Canada could lose its international edge in the area of public debt.

Table 3 – Budgetary and economic projections (version with very low growth and rise by the debt ratio)

Fiscal years	Nominal GDP* ($M)	Annual nominal GDP growth* (%)	Budget balance ($M)	Budget balance (% of GDP)	Debt representing accrued deficits ($M)	Debt ratio for accrued deficits in relation to nominal GDP** (%)
2005-2006	1,417,028	6.4	13,218	0.93	481,499	34.1
2006-2007	1,492,207	5.3	13,752	0.92	467,268	31.4
2007-2008	1,573,532	5.4	9,597	0.61	457,637	29.2
2008-2009	1,652,923	5.0	-5,755	-0.35	463,710	28.2
2009-2010	1,567,365	-5.2	-55,598	-3.55	519,097	33.1
2010-2011	1,662,130	6.0	-33,372	-2.01	550,327	33.1
2011-2012	1,769,921	6.5	-26,279	-1.48	583,576	33.0
2012-2013	1,822,808	3.0	-18,415	-1.01	609,391	33.3
2013-2014	1,892,193	3.8	-5,150	-0.27	611,881	32.3
2014-2015	1,973,043	4.3	1,911	0.10	612,330	31.0
2015-2016 e	**1,986,877**	**0.7**	**-3,000**	**-0.15**	**616,500**	**31.1**
2016-2017 p	**2,006,746**	**1.0**	**-25,659**	**-1.28**	**642,159**	**32.0**
2017-2018 p	**2,046,881**	**2.0**	**-35,359**	**-1.73**	**677,518**	**33.1**
2018-2019 p	**2,087,819**	**2.0**	**-40,692**	**-1.95**	**718,210**	**34.4**
2019-2020 p	**2,129,575**	**2.0**	**-31,401**	**-1.47**	**749,610**	**35.2**
2020-2021 p	**2,172,167**	**2.0**	**-21,509**	**-0.99**	**771,119**	**35.5**

*: Data on nominal GDP come from a regular calendar that starts in January of the previous fiscal year.
**: Due to rounding, among other factors, the results may not match the department's calculations exactly.
e: Department estimates established for the November 20, 2015 budget update.
p: Projections

DEFICITS MUST BE CONTROLLED

In conclusion, these projections demonstrate the degree of leeway the federal government has in terms of budget deficits Two cautions are in order, however. For one, budget deficits must be governed by a credible financial plan, which must be respected over the medium term. Also, the nature of the deficits is very important. Budget deficits are acceptable insofar as they are justified by an expansion to infrastructure investment or reduction to the burden on taxpayers. It would be much harder to get citizens to approve of a return to chronic deficits to finance other kinds of expenditures, given the excesses of the past and their exponential impact on the debt ratio.

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